in which the individual customarily engaged prior to the arising of the disability or prior to retirement if the individual was retired at the time the disability arose.

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered as preventing substantial gainful activity:

(i) Loss of use of two limbs;

(ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;

(iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;

(iv) Cancer which is inoperable and progressive;

(v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;

(vi) Mental diseases (e.g. psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;

(vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;

(viii) Permanent and total loss of speech;

(ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 72(m)(7), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. The term ''indefinite'' is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

[T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§ 1.72–18 Treatment of certain total distributions with respect to self-employed individuals.

(a) *In general.* The Self-Employed Individuals Tax Retirement Act of 1962 permits self-employed individuals to be treated as employees for purposes of participation in pension, profit-sharing, and annuity plans described in sections 401(a) and 403(a). In general, amounts received by a distributee or payee which are attributable to contributions made on behalf of a participant while he was self-employed are taxed in the same manner as amounts which are attributable to contributions made on behalf of a common-law employee. However, such amounts which

are paid in one taxable year representing the total distributions payable to a distributee or payee with respect to an employee are not eligible for the capital gains treatment of section 402(a)(2) or 403(a)(2). This section sets forth the treatment of such distributions, except where such a distribution is subject to the penalties of section 72(m)(5) and paragraph (e) of §1.72–17.

(b) *Distributions to which this section applies.* (1)(i) Except as provided in subparagraphs (2) and (3) of this paragraph, this section applies to amounts distributed to a distributee in one taxable year of the distributee in the case of an employees' trust described in section 401(a) which is exempt under section 501(a), or to amounts paid to a payee in one taxable year of the payee in the case of an annuity plan described in section 403(a), which constitute the total distributions payable, or the total amounts payable, to the distributee or payee with respect to an employee.

(ii) For the total distributions or amounts payable to a distributee or payee to be considered paid within one taxable year of the distributee or payee for purposes of this section, all amounts to the credit of the employee-participant through the end of such taxable year which are payable to the distributee or payee must be distributed or paid within such taxable year. Thus, the provisions of this section are not applicable to a distribution or payment to a distributee or payee if the trust or plan retains any amounts after the close of such taxable year which are payable to the same distributee or payee even though the amounts retained may be attributable to contributions on behalf of the employee-participant while he was a common-law employee in the business with respect to which the plan was established.

(iii) For purposes of this section, the total amounts payable to a distributee or the amounts to the credit of the employee do not include United States Retirement Plan Bonds held by a trust to the credit of the employee. Thus, a distribution to a distributee by a qualified trust may constitute a distribution to which this section applies even though the trust retains retirement plan bonds registered in the name of the employee on whose behalf the distribution is made which are to be distributed to the same distributee. Moreover, the proceeds of a retirement bond received as part of a distribution which constitutes the total distributions payable to the distributee are not entitled to the special tax treatment of this section. See section 405(d) and paragraph (a)(1) of §1.405–3.

(iv) If the amounts payable to a distributee from a qualified trust with respect to an employee-participant includes an annuity contract, such contract must be distributed along with all other amounts payable to the distributee in order to have a distribution to which this section applies. However, the proceeds of an annuity contract received in a total distribution will not be entitled to the tax treatment of this section unless the contract is surrendered in the taxable year of the distributee in which the total distribution was received.

(v) In the case of a qualified annuity plan, the term ''total amounts'' means all annuities payable to a payee. If more than one annuity contract is received under the plan by a distributee, this section shall not apply to an amount received on surrender of any such contracts unless all contracts under the plan payable to the payee are surrendered within one taxable year of the payee.

(vi)*(a)* The provisions of this section are applicable where the total amounts payable to a distributee or payee are paid within one taxable year of the distributee or payee whether or not a portion of the employee-participant's interest which is payable to another distributee or payee is paid within the same taxable year. However, a distributee or payee who, in prior taxable years received amounts (except amounts described in *(b)* of this subdivision) after the employee-participant ceases to be eligible for additional contributions to be made on his behalf, does not receive a distribution or payment to which this section applies, even though the total amount remaining to be paid to such distributee or payee with respect to such employee is paid within one taxable year. On the

other hand, a distribution to a distributee or payee prior to the time that the employee-participant ceases to be eligible for additional contributions on his behalf does not preclude the application of this section to a later distribution to the same distributee or payee.

(b) The receipt of an amount which constitutes—

(1) A payment in the nature of a dividend or similar distribution to an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract, or

(2) A return of excess contributions which were not willfully made,

does not prevent the application of this section to a total distribution even though the amount is received after the employee-participant ceases to be eligible for additional contributions and in a taxable year other than the taxable year in which the total amount is received.

(vii) For purposes of this section, the total amounts payable to a distributee or payee, or the amounts to the credit of the employee, do not include any amounts which have been placed in a separate account for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14. Thus, a distribution by a qualified trust or annuity plan may constitute a distribution to which this section applies even though amounts attributable to the funding of section 401(h) medical benefits as defined in paragraph (a) of §1.401–14 are not so distributed.

(2) This section shall apply—

(i) Only if the distribution or payment is made—

(a) On account of the employee's death at any time,

(b) After the employee has attained the age 59½ years, or

(c) After the employee has become disabled; and

(ii) Only to so much of the distribution or payment as is attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. Any distribution or payment, or any portion thereof, which is not so attributable shall be subject to the rules of taxation which apply to any distribution or payment that is attributable to contributions on behalf of common-law employees.

For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of §1.72–17 for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. For taxable years beginning after December 31, 1968, if this section is applicable by reason of the distribution or payment being made after the employee has become disabled, then for the taxable year in which the amounts to which this section applies are distributed or paid, there shall be submitted with the recipient's income tax return a doctor's statement as to the nature and effect of the employee's impairment.

(3) This section shall not apply to—

(i) Distributions or payments to which the penalty provisions of section 72(m)(5) and paragraph (e) of §1.72–17 apply,

(ii) Distributions or payments from a trust or plan made to or on behalf of an individual prior to the time such individual ceases to be eligible for additional contributions (except the contribution attributable to the last year of service) to be made to the trust or plan on his behalf as a self-employed individual, and

(iii) Distributions or payments made to the employee from a plan or trust unless contributions which were allowed as a deduction under section 404 have been made on behalf of such employee as a self-employed individual under such trust or plan for 5 or more taxable years (whether or not consecutive) prior to the taxable year in which such distributions or payments are made. Distributions or payments to which this section does not apply by reason of this subdivision are taxed as otherwise provided in section 72. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, is not applicable. For taxable years beginning after December 31, 1963, such distributions or payments may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(4) The portion of any distribution or payment attributable to contributions on behalf of an employee-participant while he was self-employed includes the contributions made on his behalf while he was self-employed and the increments in value attributable to such contributions. Where the amounts to the credit of an employee-participant include amounts attributable to contributions on his behalf while he was a self-employed individual and amounts attributable to contributions on his behalf while he was a common-law employee, the increment in value attributable to the employee-participant's interest shall be allocated to the contributions on his behalf while he was self-employed either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in paragraph (e)(1)(iv)*(c)* of §1.72–17. However, if the latter method is used, the numerator of the fraction is the total contributions made on behalf of the individual as a self-employed individual, weighted for the number of years that each contribution was in the plan.

(c) *Amounts includible in gross income.* (1) Where a total distribution or payment to which this section applies is made to one distributee or payee and includes the total amount remaining to the credit of the employee-participant on whose behalf the distribution or payment was made, the distributee or payee shall include in gross income an amount equal to the portion of the distribution or payment which exceeds the employee-participant's investment in the contract. For purposes of this paragraph, the investment in the contract shall be reduced by any amounts previously received from the plan or trust by or on behalf of the employee-participant which were excludable from gross income as a return of the investment in the contract.

(2) In the case of a distribution to which this section applies and which is made to more than one distributee or payee, each element of the amounts to the credit of an employee-participant shall be allocated among the several distributees or payees on the basis of the ratio of the value of the distributee's or payee's distribution or payment to the total amount to the credit of the employee-participant. The elements to be so allocated include the investment in the contract, the increments in value, and the portion of the amounts to the credit of the employee-participant which is attributable to the contributions on behalf of the employee-participant while he was a self-employed individual.

(d) *Computation of tax.* (1) The tax attributable to the amounts to which this section applies for the taxable year in which such amounts are received is the greater of—

(i) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or

(ii) 5 times the increase which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the excess of the aggregate of the amounts so received and includible in gross income over the amount of the deductions allowed the recipient for such taxable year under section 151 (relating to deduction for personal exemptions).

In any case in which the application of subdivision (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credit against tax provided by section 31 (tax withheld on wages), but shall not be reduced by any other credits against tax.

(2) The application of the rules of this paragraph may be illustrated by the following example:

Example. B, a sole proprietor and a calendar-year basis taxpayer, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. B withdrew his entire interest in the trust during 1973, for which year, without regard to the distribution, he had a net operating loss and is allowed under section 151 a deduction for one personal exemption. At the time of the withdrawal, B was 64 years old. The amount of the distribution that is includible in his gross income is $25,750. Because of B's net operating loss, the tax attributable to the distribution is determined under the rule of subparagraph (1)(ii)

of this paragraph. For purposes of determining the tax attributable to the $25,750, B's taxable income for 1973 is treated, under subparagraph (1)(ii) of this paragraph, as being 20 percent of $25,000 ($25,750 minus $750, the amount of the deduction allowed for each personal exemption under section 151 for 1973). Thus, under subparagraph (1) of this paragraph, the tax attributable to the $25,750 would be 5 times the increase which would result if the taxable income of B for the taxable year he received such amount equaled $5,000. B has had no amounts withheld from wages and thus is not entitled to reduce the increase in taxes by the credit against tax provided in section 31 and may not reduce the increase in taxes by any other credits against tax.

[T.D. 6676, 28 FR 10138, Sept. 17, 1963, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964, T.D. 6885, 31 FR 7800, June 2, 1966, T.D. 6985, 33 FR 19812, Dec. 27, 1968; T.D. 7114, 36 FR 9018, May 18, 1971]

§ 1.72(e)–1T Treatment of distributions where substantially all contributions are employee contributions. (temporary)

Q–1: How did the Tax Reform Act (TRA) of 1984 change the law with regard to the treatment of non-annuity distributions (i.e., amounts distributed prior to the annuity starting date and not received as annuities) from a qualified plan that is treated as a single contract under section 72 and under which substantially all of the contributions are employee contributions?

A–1: (a) Prior to the amendment of section 72(e) by the TRA of 1984, non-annuity distributions from such a qualified plan generally were allocable, first, to nondeductible employee contributions and thus were not includible in gross income. After distributions equaled the balance of nondeductible employee contributions, further non-annuity distributions generally were includible in gross income.

(b) Pursuant to section 72(e)(7), as added by the TRA of 1984, non-annuity distributions from such a qualified plan that are allocable to investment in the plan after August 13, 1982 (as determined in accordance with section 72(e)(5)(B)), generally will be treated, first, as allocable to income and, second, as allocable to nondeductible employee contributions. Distributions allocable to income are includible in gross income. Distributions allocable to nondeductible employee contributions are not includible in gross income.

Q–2: To which qualified plans and contracts does section 72(e)(7) apply?

A–2: Section 72(e)(7) applies to any plan or contract under which substantially all of the contributions are employee contributions if—

(a) Such plan is described in section 401(a) and the related trust or trusts are exempt from tax under section 501(a); or

(b) Such contract is—

(1) Purchased by a trust described in (a) above,

(2) Purchased as part of a plan described in section 403(a), or

(3) Described in section 403(b).

Q–3: What is the definition of a qualified plan or contract under which substantially all of the contributions are employee contributions?

A–3: (a) A qualified plan or contract under which substantially all of the contributions are employee contributions is a plan or contract with respect to which 85 percent or more of the total contributions during the ''representative period'' are employee contributions. The ''representative period'' means the five-plan-year period preceding the plan year during which a distribution occurs. However, if less than 85 percent of the total contributions for all plan years during which the plan or contract is in existence prior to the plan year of distribution are employee contributions, then the plan or contract is not one with respect to which substantially all of the contributions are employee contributions.

(b) For purposes of the 85 percent test, contributions made to a predecessor plan or contract are aggregated with contributions made to the plan or contract to which the 85 percent test is being applied (the successor plan or contract). For purposes of the preceding sentence, a predecessor plan or contract is a plan or contract the terms of which are substantially the same as the successor plan or contract.

Q–4: What is the definition of employee contributions for purposes of section 72(e)(7)?

A–4: For purposes of section 72(e)(7), employee contributions are those amounts contributed by the employee